MONTANA STATE FUND
2003 ANNUAL REPORT

MONTANA
STATEFUND

Statutory Financial Statements

MONTANA STATEFUND

2003 ANNUAL REPORT

Table of Contents

STATUTORY STATEMENTS OF ADMITTED ASSETS, LIABILITIES AND SURPLUS

ADMITTED ASSETS

	2003	2002
INVESTMENTS [1]		
Bonds	**$ 436,818,298**	$ 415,322,318
Equity Securities	**69,958,153**	64,180,639
Cash and Short-Term Investments	**32,150,786**	22,034,873
Other Investments - Collateral Securities on Loan	**30,968,721**	57,563,169
Total Investments and Cash	**569,895,958**	559,100,999
OTHER ADMITTED ASSETS		
Premium Receivables	**7,354,843**	7,365,247
Equipment (net)	**815,820**	842,983
Interest Receivable	**6,586,054**	6,441,102
Other Assets	**186,713**	1,173,510
Total Admitted Assets	**$ 584,839,388**	$ 574,923,841

LIABILITIES AND SURPLUS

	2003	2002
LIABILITIES [2]		
Losses Incurred Reserves	**$ 372,300,000**	$ 308,700,000
Loss Adjustment Expense Reserves	**41,100,000**	37,700,000
Liability for Securities on Loan	**30,968,721**	57,563,169
Deferred Revenue	**202,912**	583,980
Other Liabilities	**18,668,338**	11,877,697
Total Liabilities	**463,239,971**	416,424,846
CONTINGENCIES AND SUBSEQUENT EVENTS		
SURPLUS [3]		
Policyholders' Surplus	**121,599,417**	158,498,995
Total Liabilities and Surplus	**$ 584,839,388**	$ 574,923,841

1. See Note B on Page 10
2. See Note F on Page 14
3. See Note L on Page 19

The accompanying notes are an integral part of these financial statements.

STATUTORY STATEMENTS OF REVENUE AND EXPENSES AND CHANGES IN SURPLUS

	2003	2002
Net Premium Earned	**$ 117,776,580**	$ 92,971,868
Losses Incurred	**(146,912,095)**	(86,699,328)
Loss Expenses Incurred	**(16,074,946)**	(12,883,989)
Underwriting Expenses Incurred	**(17,559,701)**	(15,024,225)
Net Underwriting Loss	**$ (62,770,162)**	$ (21,635,674)
Net Investment Income Earned	**26,799,946**	29,112,843
Net Realized Capital Gains (Losses)	**2,126,151**	4,351,624
Premium Balances Recovered (Charged Off)	**(686,078)**	(445,304)
Other Income	**16,796**	411,018
Net Income (Loss) Before Dividends	**(34,513,347)**	11,794,507
Policyholder Dividends	**(2,949,597)**	(4,001,224)
Net Income (Loss) After Dividends	**(37,462,944)**	7,793,283
Prior Year End Surplus	**158,498,995**	150,879,539
Net Unrealized Gains (Losses) on Equity Securities	**777,514**	(9,523,024)
Change in Non-admitted Assets	**(156,802)**	4,223,294
Cumulative Effect of Change in Accounting Principle		
Due to Codification	**-**	(2,242,469)
Aggregate Write In for Gains (Losses) in Surplus	**(56,058)**	(14,140)
Transfer In (Out), net	**(1,288)**	7,382,512
END OF PERIOD SURPLUS	**$ 121,599,417**	$ 158,498,995

The accompanying notes are an integral part of these financial statements.

STATUTORY STATEMENTS OF CASH FLOWS

	2003	2002
CASH FLOWS FROM OPERATIONS		
Premiums Collected Net of Reinsurance	**$ 116,817,578**	$ 104,398,909
Loss and Loss Adjustment Expenses Paid	**(95,987,041)**	(79,083,317)
Underwriting Expenses Paid	**(16,561,430)**	(14,033,481)
Cash Provided by Underwriting	**4,269,107**	11,282,111
Net Investment Income	**26,839,494**	29,922,768
Other Income (Expenses):		
Agents' Balances Charged Off	**(686,078)**	(445,304)
Net Funds Held Under Reinsurance Treaties	**(36,000)**	(36,000)
Net Amount Withheld or Retained for Account of Others	**4,207,231**	(1,390,484)
Miscellaneous Income (Expense)	**(26,958,720)**	(30,715,094)
Cash Used for Other Income (Expense)	**(23,473,567)**	(32,586,882)
Dividends to Policyholders	**(2,949,597)**	(4,001,224)
Net Cash Provided by Operations	**4,685,437**	4,616,773
CASH FLOWS FROM INVESTMENTS		
Proceeds from Investments Sold, Matured or Repaid:		
Bonds	**104,583,815**	151,192,132
Change in Collateral Securities	**26,594,448**	31,126,112
Total Investment Proceeds	**131,178,263**	182,318,244
Cost of Investments Acquired (long-term only):		
Bonds	**(126,624,440)**	(141,521,244)
Stock	**(5,000,000)**	(50,000,000)
Cost of Investment Acquired	**(131,624,440)**	(191,521,244)
Net Cash Used For Investments	**(446,177)**	(9,203,000)
CASH FLOWS FROM FINANCING AND MISC. SOURCES		
Cash Provided or (Applied):		
Changes in Surplus	**25,875**	10,726,844
Transfers from Affiliates	**834,848**	438,160
Other Applications	**5,015,930**	(15,573,363)
Net Cash Provided by (Used for) Financing and Miscellaneous Sources	**5,876,653**	(4,408,359)
NET INCREASE (DECREASE) IN CASH AND SHORT TERM INVESTMENTS	**10,115,913**	(8,994,586)
CASH AND SHORT TERM INVESTMENTS - BEGINNING OF YEAR	**22,034,873**	31,029,459
CASH AND SHORT TERM INVESTMENTS - END OF YEAR	**$ 32,150,786**	$ 22,034,873

The accompanying notes are an integral part of these financial statements.

NOTE A - ORGANIZATION, BASIS OF PRESENTATION, AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

1. Organization

The Montana State Fund (MSF) is a nonprofit, quasi-public entity established under Title 39, Chapter 71 of the Montana Code Annotated (MCA). MSF provides Montana employers with an option for workers' compensation and occupational disease insurance and guarantees available coverage for all employers in Montana. MSF is governed by a seven member Board of Directors appointed by the Governor. MSF is a component unit of the State of Montana. MSF is attached to the State of Montana, Department of Administration for administrative purposes only. MSF governs, operates and completes its financial reporting as an insurance company domiciled in the State of Montana.

MSF functions as an autonomous insurance entity supported solely from its own revenues. All assets, debts, and obligations of MSF are separate and distinct from assets, debts, and obligations of the State of Montana. State law requires MSF to set premiums at least annually at a level sufficient to ensure adequate funding of the insurance program during the period the rates will be in effect. If MSF is dissolved by an act of law, the money in MSF is subject to the disposition provided by the legislature enacting the dissolution with due regard given to obligations incurred and existing (Section 39-71-2322, MCA).

During the 1990 Montana Special Legislative Session, legislation passed establishing separate funding and accounts for claims of injuries resulting from accidents occurring before July 1, 1990, referred to as the Old Fund, and claims occurring on or after July 1, 1990, referred to as the New Fund (MSF). This report reflects only the operations of the Montana State Fund (New Fund only). MSF administers and manages the remaining claims of the Old Fund on behalf of the State of Montana and receives an administrative fee.

State law required that any excess surplus in the Old Fund above an amount deemed as adequately funded by state law up to $63.8 million be transferred to MSF. However, during the 2003 Montana Legislature, House Bill Number 363 (HB 363) was enacted and changes existing law regulating the Old Fund transfer of surplus. As a result of HB 363, any excess Old Fund surplus is to be transferred to the State of Montana General Fund rather than to MSF.

2. Basis of Presentation

The accompanying financial statements of MSF have been prepared in conformity with accounting practices prescribed and permitted by the State of Montana Department of Insurance. Such practices vary from accounting principles generally accepted in the United States of America (GAAP) principally in that certain assets reportable under GAAP are "non-admitted" and have been excluded from the accompanying statutory statements of Assets, Liabilities and Surplus and charged directly to net worth and that certain investments which would be carried at estimated fair value under GAAP are carried at amortized cost.

The State of Montana Department of Insurance recognizes only statutory accounting practices prescribed or permitted by the State of Montana for determining and reporting the financial condition and results of operations of an insurance company. The National Association of Insurance Commissioners' (NAIC) *Accounting Practices and Procedures* manual, version effective January 1, 2001, (NAIC SAP) has been adopted as a component of prescribed or permitted practices by the State of Montana. MSF's net income (loss) and surplus as stated on a NAIC SAP basis and on the basis of practices prescribed or permitted by the State of Montana are the same at June 30, 2003 and 2002.

NOTE A - ORGANIZATION, BASIS OF PRESENTATION, AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES, continued

2. Basis of Presentation, continued

Accounting changes adopted to conform to the NAIC are reported as changes in accounting principles and are reported as an adjustment to unassigned surplus in the period of the change in accounting principle. As a result of these changes, MSF reported a change of accounting principle as an adjustment that decreased unassigned surplus of $2,242,469 as of July 1, 2001 and for the year ended June 30, 2002.

The Montana Code Annotated references conformity with the Accounting Practices and Procedures Manual within section 33-2-701(1) and therefore concludes that no legislation is necessary to adopt its use.

3. Significant Accounting Policies

Cash and Cash Equivalents - Cash constitutes a medium of exchange that a bank or other similar financial institution will accept for deposit and allow an immediate credit to the depositor's account. Also classified as cash are savings accounts, certificates of deposits with maturity dates of one year or less, and cash equivalents. Cash equivalents are: investments with original maturities of three months or less; are readily convertible to known amounts of cash; and, present insignificant risk of change in value due to changes in interest rates. The Montana State Treasury holds MSF's cash and cash equivalent balances.

Short-term Investments - Short-term investments are those investments with remaining maturities of one year or less at the time of acquisition, excluding those investments classified as cash equivalents. Short-term investments include but are not limited to, bonds, commercial paper, money market instruments, repurchase agreements, and collateral and mortgage loans that meet the above criteria. Short-term investments shall not include certificates of deposit.

Premium Receivable – Premium receivable balances with an amount due over 90 days are non-admitted assets. The MSF evaluates the remaining admitted accounts receivable asset for impairment. If it is probable that any amounts are not collectible, the uncollectible receivable is written off and charged to income in the period the determination is made.

Risks and Uncertainties - Risks and uncertainties existing as of the date of the financial statements, are as follows:

Use of Estimates - The preparation of financial statements in conformity with Statutory Accounting Principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the period. Actual results could differ from those estimates.

Loss and LAE Reserves - Loss and loss adjustment expense (LAE) reserves are established to provide for the estimated ultimate settlement cost of all claims incurred. Management believes that the reserves for unpaid losses and loss adjustment expenses are adequate; however, there can be no assurance that the ultimate settlement of losses may not vary materially from the estimate recorded. Since liabilities are based on estimates, the ultimate liability may be in excess of, or less than, the amounts provided. Adjustment to these estimates of reserves will be reflected in the Statutory Statement of Revenue and Expenses in future years.

NOTE A - ORGANIZATION, BASIS OF PRESENTATION, AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES, continued

3. Significant Accounting Policies, continued

Uncertainty Due to Litigation - In the ordinary course of business, MSF is a defendant in various litigation matters. Although there can be no assurances, as of June 30, 2003 and 2002, in the opinion of MSF's management based on information currently available, the ultimate resolution of these legal proceedings would not be likely to have a material adverse effect on its statutory results of revenue and expenses, admitted assets, liabilities and surplus or liquidity. For further discussion, refer to Note J (Contingencies, Uncertainties and Subsequent Events).

Vulnerability Due to Certain Concentrations - MSF uses approximately 48 agencies located throughout Montana to write workers compensation policies with gross written premiums of $76,863,767 for the year ended June 30, 2003. MSF conducts its business within the State of Montana for the most part and is susceptible to risk based on the economy of the geographic territory it serves.

Administrative Cost Allocation - State law requires MSF to separately determine and account for administrative expenses and benefit payments for claims for injuries resulting from accidents occurring before July 1, 1990 (Old Fund) from those occurring on or after July 1, 1990 (MSF). The law also limits annual administrative costs of claims associated with the Old Fund to $1,250,000 for fiscal years 2003 and 2002, respectively. The Montana State Fund allocated $1,250,000 in administration costs to the Old Fund in fiscal years 2003 and 2002, respectively. The Old Fund has a $1,075,781 contingent obligation to the Montana State Fund in unrecovered administrative costs incurred in fiscal years prior to 2002-2003; consequently, it is not recorded on these financial statements. MSF intends to recover this amount in future years where the cost of administering the Old Fund is less than the statutorily permitted $1,250,000.

Long-Term Securities - Long-term securities consist of equity securities and bonds. Long-term securities are held by the Montana Board of Investments (BOI) and State Street Bank is the custodial bank for the BOI. Equity securities are valued at fair market value. Bonds are rated and valued in accordance with the Securities Valuation Office (SVO) rating guidelines. Bonds with a SVO rating of 1 and 2 are valued at amortized cost. Bonds with a SVO rating of 3 or higher are valued at the lower of cost or market. Bond amortization is calculated using the straight-line method. In accordance with SSAP 26, bond amortization shall be calculated using the scientific (constant yield) interest method. MSF is not able to obtain this information from its fund manager at this time. Management believes the difference between the straight-line method and the scientific method is immaterial to the current year Statutory Statements of Revenue and Expenses and Changes in Surplus and is not able to determine the cumulative impact to the Statutory Statements of Admitted Assets, Liabilities and Surplus. MSF has no derivative investments.

Electronic Computer Equipment and Software - Electronic computer equipment is recorded at cost and depreciated on a straight-line basis over an estimated useful life of three years. Equipment is capitalized if the actual or estimated historical cost exceeds $5,000. Software is amortized on a straight-line basis using a three-year life for operating software and a five-year life for application software.

NOTE A - ORGANIZATION, BASIS OF PRESENTATION, AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES, continued

3. Significant Accounting Policies, continued

Furniture, Equipment and Leasehold Improvements - Furniture and equipment are recorded at cost and depreciated on a straight-line basis using estimated useful lives, which range from five to ten years. There are no leasehold improvements to property owned by the State of Montana and used by MSF requiring amortization. SSAP 16 requires that furniture, fixtures, equipment and leasehold/property improvements be capitalized, depreciated and non-admitted.

Losses Incurred and Loss Adjustment Expense Estimates – Loss and loss adjustment expense (LAE) reserves are established to provide for the estimated ultimate settlement cost of all claims incurred. Loss reserves are based on reported aggregate claim cost estimates combined with estimates for future development of such claim costs and estimates of incurred but not reported (IBNR) claims. Tillinghast-Towers Perrin, an external actuarial firm, prepares an actuarial study used to estimate liabilities and the ultimate cost of settling claims reported but not settled and IBNR as of June 30, 2003 and 2002. The study provides a range of potential cost associated with the reported claims, the future development of those claims and IBNR. MSF management has selected the best estimates within that range as the estimated loss reserves. Because actual claim costs depend on such complex factors as inflation and changes in the law, claim liabilities are recomputed periodically using a variety of actuarial and statistical techniques to produce current estimates that reflect recent settlements, claim frequency, and other economic and social factors.

A provision for inflation and the calculation of estimated future claim costs is implicit in the calculation because reliance is placed both on actual historical data that reflect past inflation and on other factors that are considered to be appropriate modifiers of past experience. As of June 30, 2003 and 2002, $413,400,000 and $346,400,000, respectively, of unpaid claims and claim adjustment expenses are presented at face value net of estimated reinsurance recoverable.

Reinsurance Recoverables on Paid and Unpaid Losses - Reinsurance recoverables are estimates of paid and unpaid losses collectible from MSF's reinsurers. The amounts ultimately collected may be more or less than these estimates. Any adjustments of these estimates are reflected in income, as they are determined.

Deferred Revenue - Deferred revenue reflects amounts billed or received in advance, but not yet earned for policies effective July 1, 2003 and 2002, respectively.

Other Liabilities consist of:

- **Security Deposits** - Security deposits are monies held on behalf of certain insured's due to their loss ratios and payment histories as well as due to particular payment terms. In addition, funds withheld per the reinsurance contract are also included in this account.
- **Accounts Payable** - Accounts payable includes liabilities incurred on behalf of claimants, refunds due to policyholders and amounts due to vendors.
- **Compensated Absences** - MSF supports two leave programs, the State of Montana Leave Program and the MSF Personal Leave Program, implemented in January 2002. The State of Montana Leave Program covers all union represented employees. Union represented employees accumulate both annual leave and sick leave and MSF pays employees 100% of unused annual leave and 25% of unused sick leave upon termination. MSF also pays 100% of unused compensatory leave credits upon termination to nonexempt employees.

NOTE A - ORGANIZATION, BASIS OF PRESENTATION, AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES, continued

3. Significant Accounting Policies, continued

- **Compensated Absences,** continued - MSF Personal Leave Program covers all non-union employees. Non-union employees accumulate personal leave and extended leave. MSF pays employees 100% of unused personal leave upon termination but extended leave has no cash value at the time of termination. MSF absorbs expenses for termination pay in its annual operational costs. MSF had a total leave accrued liability of $1,417,926 and $1,269,788 at June 30, 2003 and 2002, respectively

Income Taxes Payable - MSF is a component unit of the State of Montana and is not subject to Federal or State premium tax.

Premium Revenue - Premiums are recognized as revenue on a pro-rata basis over the policy period, beginning on the effective date of the policy. Advance premiums are deferred until the effective date of the policy at which time they are recognized as revenue on a pro-rata basis over the term of the policy. MSF's Board of Directors approves premium rates annually. Revenue from premiums is recognized over the term of the policy year. Policyholders are contractually obligated to pay certain premiums to MSF in advance of the period the premiums are earned. Premium advances are refundable when the policyholder's coverage is canceled and MSF has credited all earned premiums. Expenses incurred in connection with acquiring new insurance business, including such acquisition costs as sales commissions, are charged to operations as incurred.

Policyholder Dividends - The amount of dividends to be paid to policyholders is determined annually by MSF's Board of Directors. The aggregate amount of policyholders' dividends is related to the financial results for the year and to the appropriate level of statutory surplus to be retained by MSF.

NOTE B - INVESTMENTS

The investments of MSF as of June 30, 2003 and 2002 are as follows:

SUMMARY INVESTMENT SCHEDULE

June 30, 2003	Total Investment Holdings	Percentage
Bonds:		
U.S. Government Issuer Obligations	$ 151,604,707	26.6%
U.S. Government Single Class Mortgage-Backed/ Asset-Backed Securities	9,938,587	1.7%
Special Revenue and Special Assessment Obligations	58,112,993	10.2%
Public Utilities	19,575,476	3.4%
Industrial and Miscellaneous Unaffiliated Issuer Obligations	156,320,425	27.5%
Industrial and Miscellaneous Other Multi-Class Commercial Mortgage-Backed/Asset-Backed Securities	41,266,110	7.3%
Total Bonds	**436,818,298**	**76.7%**
Unaffiliated Publicly Traded Equity Securities	69,958,153	12.3%
Cash and Short-Term Investments	32,150,786	5.6%
Other Invested Assets	30,968,721	5.4%
Total Invested Assets	**$ 569,895,958**	**100.0%**

June 30, 2002	Total Investment Holdings	Percentage
Bonds:		
U.S. Government Issuer Obligations	$ 120,795,533	21.6%
U.S. Government Single Class Mortgage-Backed/ Asset-Backed Securities	29,664,936	5.3%
Public Utilities	9,435,287	1.7%
Industrial and Miscellaneous Unaffiliated Issuer Obligations	231,533,510	41.5%
Industrial and Miscellaneous Single Class Mortgage-Backed/ Asset-Backed Securities	4,658,803	0.8%
Industrial and Miscellaneous Other Multi-Class Commercial Mortgage-Backed/Asset-Backed Securities	19,234,249	3.4%
Total Bonds	**415,322,318**	**74.3%**
Unaffiliated Publicly Traded Equity Securities	64,180,639	11.5%
Cash and Short-Term Investments	22,034,873	3.9%
Other Invested Assets	57,563,169	10.3%
Total Invested Assets	**$ 559,100,999**	**100.0%**

NOTE B - INVESTMENTS, continued

The amortized cost and market value of securities as of June 30, 2003 are as follows:

June 30, 2003	Amortized Cost	Gross Unrealized Gain	Gross Unrealized Loss	Market Value
Bonds:				
U.S. Government Issuer Obligations	$ 151,604,707	$ 13,548,818	$ -	$ 165,153,525
U.S. Gov. Single Class Mortgage-Backed/ Asset-Backed Securities	9,938,587	-	11,093	9,927,494
Special Revenue/Assessment Obligations	58,112,993	2,730,890	-	60,843,883
Public Utilities	19,575,476	2,079,898	-	21,655,374
Industrial and Miscellaneous Unaffiliated Issuer Obligations	156,320,425	15,382,992	-	171,703,417
Ind. and Misc. Commercial Unaffiliated Mortgage-Backed/Asset-Backed Securities	41,986,572	1,815,437	720,462	43,081,547
Subtotal	437,538,760	35,558,035	731,555	472,365,240
Bond Write Down due to SVO Rating	(720,462)			-
Total Bonds	$ 436,818,298			$ 472,365,240
Unaffiliated Publicly Traded Equity Securities	**$ 79,000,000**	**$ -**	**$ 9,041,847**	**$ 69,958,153**

The amortized cost and estimated market value of MSF's fixed maturity securities as of June 30, 2003 and 2002, are shown below at contractual maturity. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

June 30, 2003	Carrying Value	Market Value
Due one year or less (excludes STIP)	$ 9,688,914	$ 9,875,934
Due after one year through five years	134,969,918	148,798,953
Due after five years through ten years	175,587,858	191,300,916
Due after ten years	116,571,608	122,389,437
Totals	$ 436,818,298	$ 472,365,240

June 30, 2002	Carrying Value	Market Value
Due one year or less (excludes STIP)	$ 6,972,244	$ 6,989,324
Due after one year through five years	141,183,158	149,356,828
Due after five years through ten years	127,324,455	132,291,958
Due after ten years	139,842,461	143,335,788
Totals	$ 415,322,318	$ 431,973,898

During fiscal year ending June 30, 2003 MSF realized gross gains from sales of securities of $3,112,888 and gross realized losses of $986,736. During fiscal year ending June 30, 2002, MSF realized gross gains from sales of securities of $6,569,674 and gross realized losses of $2,218,050.

NOTE C - CASH COLLATERAL AND LIABILITY FOR SECURITIES ON LOAN

Under the provisions of state statutes, the Montana Board of Investments (BOI) has, by a Securities Lending Authorization Agreement, authorized the custodial bank, State Street Bank, to lend BOI's securities to broker-dealers and other entities with a simultaneous agreement to return the collateral for the same securities in the future. State Street Bank was appointed the BOI's custodial bank on December 1, 1993. During the period the securities are on loan, BOI receives a fee and the bank must initially receive collateral equal to 102% of the market value of the securities on loan and must maintain collateral equal to not less than 100% of the market value of the loaned security. BOI retains all rights of ownership during the loan period. The cash collateral received on each loan was invested, together with the cash collateral of other qualified plan lenders, in a collective investment pool, the Securities Lending Quality Trust. The relationship between the average maturities of the investment pool and BOI's loans was affected by the maturities of the loans made by other plan entities that invested cash collateral in the collective investment pool, which BOI could not determine. On June 30, 2003 and June 30, 2002, BOI had no credit risk exposure to borrowers.

The following table presents the carrying and market values of the securities on loan and the total collateral held for fiscal years 2003 and 2002:

	Fiscal Year 2003	**Fiscal Year 2002**
Securities on Loan – Book Value	$26,912,989	$52,188,972
Securities on Loan – Market Value	$30,180,923	$55,652,152
Total Collateral Held	**$30,968,721**	**$57,563,169**

NOTE D - SHORT-TERM INVESTMENTS

MSF participates in the Short-Term Investment Pool (STIP) maintained by BOI. STIP balances are highly liquid investments. There are no legal risks that BOI is aware of regarding STIP investments. The market value of STIP approximates cost.

The STIP investments' credit risk is measured by investment grade ratings given individual securities. BOI's policy requires that STIP investments have the highest rating in the short-term category by one and/or any Nationally Recognized Statistical Rating Organizations (NRSRO). The four NRSRO's include Standard and Poor's, Moody's Investors Service, Fitch, Inc. and Dominion Bond Rating Service Ltd.

NOTE E - ELECTRONIC COMPUTER EQUIPMENT AND SOFTWARE

Electronic computer equipment is recorded at cost and depreciated on a straight-line basis over an estimated useful life of three years. Equipment is capitalized if the actual or estimated historical cost exceeds $5,000. Software is amortized on a straight-line basis using a three-year life for operating software and a five-year life for application software.

Balances June 30, 2003	Equipment and Operating Software	Application Software	Total
Assets	2,276,039	8,297,736	10,573,775
Accumulated Depreciation	1,460,219	6,187,366	7,647,585
Net Assets Nonadmitted	-0-	2,110,370	2,110,370
Net Assets Admitted	815,820	-0-	815,820
Depreciation Expense	434,409	1,192,259	1,626,668
Balances June 30, 2002			
Assets	2,157,978	8,092,119	10,250,097
Accumulated Depreciation	1,314,995	4,994,282	6,309,277
Net Assets Nonadmitted	-0-	3,097,837	3,097,837
Net Assets Admitted	842,983	-0-	842,983
Depreciation Expense	269,139	1,200,211	1,469,350

Furniture and Equipment - Furniture and equipment are recorded at cost and depreciated on a straight-line basis using estimated useful lives, which range from five to ten years.

SSAP 16 requires that furniture, fixtures and equipment be capitalized, depreciated and nonadmitted.

	Furniture and Equipment June 30, 2003	Furniture and Equipment June 30, 2002
Assets	694,066	936,859
Accumulated Depreciation	385,925	588,088
Net Assets Nonadmitted	308,141	348,771
Net Assets Admitted	-0-	-0-
Depreciation Expense	98,958	52,901

Building - The 1981 Legislature appropriated funds for the construction of the Workers' Compensation building. As of July 1, 1990, MSF transferred the value of the building from its records to the Department of Administration, which owns most other state buildings. Under the agreement, MSF pays all costs associated with the building, including utilities, property taxes, janitorial services, and maintenance.

Nonadmitted Assets - Certain assets designated as "nonadmitted" are excluded from the Statutory Statement of Admitted Assets. Liabilities and Surplus and the change in such assets are charged directly to unassigned surplus.

Change in Accounting Principle - During fiscal year 2002 the useful lives of computer equipment and intangible assets were permanently reduced to three and five years, respectively. As a result, a change in accounting principle of $2,242,469 is recognized at June 30, 2002.

NOTE F - LOSS AND LOSS ADJUSTMENT RESERVES

Loss and loss adjustment expense (LAE) reserves are established to provide for the estimated ultimate settlement cost of all claims incurred. Loss reserves are based on reported aggregate claim cost estimates combined with estimates for future development of such claim costs and estimates of incurred but not reported (IBNR) claims. Tillinghast-Towers Perrin, an external actuarial firm, prepares an actuarial study used to estimate liabilities and the ultimate cost of settling claims reported but not settled and IBNR as of June 30, 2003 and 2002. The study provides a range of potential cost associated with the reported claims, the future development of those claims and IBNR. MSF management has selected the best estimates within that range as the estimated loss reserves. Because actual claim costs depend on such complex factors as inflation and changes in the law, claim liabilities are recomputed periodically using a variety of actuarial and statistical techniques to produce current estimates that reflect recent settlements, claim frequency, and other economic and social factors. Management believes that the reserves for unpaid losses and loss adjustment expenses are adequate; however, there can be no assurance that the ultimate settlement of losses may not vary materially from the estimate recorded. Since liabilities are based on estimates, the ultimate liability may be in excess of, or less than, the amounts provided. Adjustment to these estimates of reserves will be reflected in the Statutory Statement of Operations in future years.

The following analysis provides a reconciliation of the activity in the reserve for losses and loss adjustment expenses.

	Years Ended June 30,	
	2003	2002
At beginning of year:		
Net reserves for losses and loss expenses	**$ 346,400,000**	$ 325,900,000
Losses and loss expenses incurred:		
Current year	**116,597,841**	84,369,719
Prior years	**35,366,198**	5,361,281
Total	**151,964,039**	89,731,000
Losses and loss expenses paid:		
Current year	**(22,981,961)**	(16,693,000)
Prior years	**(61,982,078)**	(52,538,000)
Total	**(84,964,039)**	(69,231,000)
Total unpaid claims and claim adjustment expenses at end of the year	**$ 413,400,000**	$ 346,400,000

NOTE G - RETIREMENT PLANS, DEFERRED COMPENSATION AND POSTRETIREMENT PLANS

MSF and its employees contribute to the Public Employees Retirement System (PERS), which offers two types of retirement plans administered by the Public Employees' Retirement Board (PERB). The first plan is the Defined Benefit Retirement Plan (DBRP), a multiple-employer, cost-sharing plan that provides retirement, disability and death benefits to plan members and their beneficiaries. Benefits are based on eligibility, years of service and highest average compensation. Vesting occurs once membership service totals five years. Benefits are established by state law and can only be amended by the legislature.

NOTE G - RETIREMENT PLANS, DEFERRED COMPENSATION AND POSTRETIREMENT PLANS, continued

The second plan is the Defined Contribution Retirement Plan (DCRP), created by the 1999 legislature and available to all active PERS members effective July 1, 2002. This plan is a multiple-employer, cost-sharing plan that also provides retirement, disability and death benefits to plan members and their beneficiaries. Benefits are based on the balance in the member's account, which includes the total contributions made, the length of time the funds have remained in the plan and the investment earnings less administrative costs.

Eligible PERS members choose to participate in either the DBRP or DCRP but may not be active members of both plans. MSF and its employees are required to contribute 6.9% of annual compensation in fiscal years 2003 and 2002. MSF's contributions amounted to $710,575 for fiscal year 2003 and $722,628 for fiscal year 2002. MSF and its employees paid one hundred percent of required contributions to PERS and there is no unpaid liability as of June 30, 2003.

MSF and its employees are eligible to participate in the State of Montana Deferred Compensation Plan (457 plan) administered by the PERB. The Deferred Compensation plan is a voluntary, tax-deferred retirement plan designed as a supplement to other retirement plans. Under the plan, eligible employees elect to defer a portion of their salary until future time periods. MSF incurs no costs for this plan.

NOTE H - POLICYHOLDERS' DIVIDENDS

During fiscal year 2003 and 2002, the MSF's Board of Directors authorized a dividend to be paid to policyholders of record during policy years 2001 and 2000, respectively.

Payment of the dividend totaling $2,949,597 was accomplished during May 2003 and the payment totaling $4,001,224 was accomplished during May 2002.

NOTE I - REINSURANCE ASSUMED AND CEDED

For the fiscal years ended June 30, 2003 and June 30, 2002 MSF ceded reinsurance to other reinsurance companies to limit the exposure arising from large losses. These arrangements consist of excess of loss contracts that protect against occurrences over stipulated amounts and an aggregate stop loss contract. The excess of loss contracts provide coverage of $95,000,000 and $112,000,000 for fiscal years 2003 and 2002, respectively. During fiscal year 2003 MSF retained the first $5,000,000 for the first layer of reinsurance coverage. During fiscal year 2002 MSF retained the first $3,000,000 with a $500,000 aggregate annual deductible for the first layer of reinsurance coverage. Individual, per person coverage was provided up to $5,000,000 per any one individual loss for both fiscal years 2003 and 2002.

The term of the current aggregate stop loss contract is July 1, 2002 through June 30, 2005. The contract provides coverage based on MSF's premium levels with maximum coverage of $21,000,000 in the aggregate or $8,600,000 per year. The previous aggregate stop loss contract was commuted prior to June 30, 2002. In the event reinsurers are unable to meet their obligations under either the excess of loss contracts or aggregate stop loss contract, MSF would remain liable for all losses, as the reinsurance agreements do not discharge MSF from its primary liability to the policyholders.

NOTE I - REINSURANCE ASSUMED AND CEDED, continued

Premium revenue is reduced by premiums paid for reinsurance coverage of $5,653,833 in fiscal year 2003. The aggregate stop loss contract requires that MSF maintain a funds withheld account which represents the basic premium portion of the total premium paid for aggregate stop loss coverage. The funds withheld account at June 30, 2003 is $2,150,000 with accrued interest of $143,193, which must be accrued quarterly at an annual rate of 6.5%.

As the result of commuting the previous aggregate stop loss contract on June 30, 2002, premium revenue for fiscal year 2002 is increased by $464,760 due to the reversal of the funds withheld account which offset 2002 premiums paid for reinsurance coverage.

During fiscal years 2003 and 2002, estimated claim reserves were reduced $8,000,000 and $6,500,000 respectively, for the amount of reinsurance estimated to be ultimately recoverable on incurred losses.

MSF also has assumed reinsurance relationships with Argonaut Insurance Company, Fireman's Fund Insurance Company and Legion Insurance Company related to Other States Coverage (OSC). MSF assumes risk for OSC claims, which are then covered under MSF's ceded reinsurance contract. Assumed premium for fiscal years 2003 and 2002 is $1,598,124 and $1,582,559, respectively.

NOTE J - CONTINGENCIES, UNCERTAINTIES AND SUBSEQUENT EVENTS

Contingencies

Broeker v. State Fund. The issue in this case involved the way insurers calculated the social security disability offset rates on certain claims. The Workers' Compensation Court decision stated that where there is a cost of living increase built into the initial entitlement to social security disability benefits, the workers' compensation insurer cannot take the cost of living increase into consideration when computing the social security disability offset rate. There is a cost of living offset built into the initial social security entitlement in those claims where the injured worker did not apply for social security disability close to the date of injury.

On appeal, the Montana Supreme Court affirmed the Workers' Compensation Court decision. This decision appears to affect those similarly situated claimants. The case was settled and approved by the court. The settlement provides for review of certain claims and the Montana State Fund is proceeding in accordance with the terms of the settlement. The process is nearly complete. A second related case, Buckley, is currently filed before the Workers' Compensation Court, to address the treatment of offsets on Social Security auxiliary benefits. It is a requested common fund and it is probable it will be established as one by the court.

Murer, et al v. Montana State Compensation Mutual Insurance Fund, et al. WCC No. 9206-6487, involves the 1987 legislature's capping of workers' compensation benefits ($299.00 a week for total benefits and $149.50 a week for partial benefits) for injuries occurring during the period July 1, 1987 through June 30, 1989. The 1989 legislature reenacted those caps for the period July 1, 1989 through June 30, 1991 for injuries occurring between July 1, 1989 and June 30, 1991. The Montana Supreme Court found that these caps should have expired on June 30, 1989 for injuries occurring between July 1, 1987 and June 30, 1989 and should have expired on June 30, 1991 for injuries occurring between July 1, 1989 and June 30, 1991. As a result, the Montana State Fund, under Workers' Compensation Court direction, performed a review of approximately 7500 claims. Those claims qualifying are paid 85% of the increased rate, with 15% paid to the claimant attorney. Cost impact is estimated to be over $1 million but with a cost no greater than $2 million. The cost impact has been paid or is included in Montana State Fund's loss reserves. The review and payment process is near finalization, but ongoing.

NOTE J - CONTINGENCIES, UNCERTAINTIES AND SUBSEQUENT EVENTS, continued

State Compensation Insurance Fund v. George Berg, et al. Case No. DV-99-34 (Fergus County) is a pending suit against a former policyholder in which the Montana State Fund claims the policyholder failed to pay workers' compensation insurance premiums, plus interest on the unpaid premiums. The total claim was originally for $1,045,954.49, but on further evaluation has been reduced to approximately $660,000. Berg filed a counterclaim against the Montana State Fund on various claims, seeking unspecified damages. Montana State Fund does not think the counterclaim has merit, but there is a remote chance of an adverse judgment against the Montana State Fund. This matter was expected to go to trial sometime during 2001. However, Berg filed a Chapter 11 bankruptcy petition in Montana Bankruptcy Court, which stayed any further proceedings in the state court action. The Montana State Fund entered into a tentative settlement with Berg for payment of $100,000 cash, plus $125,000 payable over time. This settlement was subject to approval by the bankruptcy court in a Chapter 11 plan of reorganization. However, the bankruptcy court converted the case to a Chapter 7 liquidation. This had the effect of resurrecting the Montana State Fund's original claim amount of $660,000. The bankruptcy trustee is now liquidating Berg's bankruptcy estate. At this time, Montana State Fund is not certain how much of this claim will be recovered.

Stavenjord v. State Compensation Insurance Fund. The Stavenjord decision was issued by the Workers' Compensation Court on May 22, 2001. It addressed the issue of whether the failure of the Occupational Disease Act (ODA) to provide PPD (permanent partial disability) benefits equivalent to the benefits provided in the Montana WCA (workers' compensation act) violates the claimant's right to equal protection of the law. Relying on the Henry case (previous case from the Supreme Court finding that vocational rehabilitation benefits must also be paid under the ODA), the court said it did, holding "Where PPD benefits calculated pursuant to the WCA are greater than the benefits available to a claimant under the ODA, constitutional equal protection guarantees require that benefits be computed and paid in accordance with the WCA. The claimant in this case is entitled to $27,027 under the WCA, versus $10,000 under the ODA." The case was affirmed by the Montana Supreme Court on April 1, 2003. Retroactive application of the decision and its status as a common fund is presently before the Workers' Compensation Court in ongoing litigation. The decision of the Workers' Compensation Court will likely be appealed to the Montana Supreme Court by at least one of the parties. Should the ultimate decision of the Montana Supreme Court be to create a common fund and apply the decision retroactively, the cost is estimated at $15 to $20 million dollars. Should the ultimate decision of the Montana Supreme Court be to apply the decision retroactively, the impact on the Old Fund liability for claims that occurred before July 1, 1990 is estimated at $5 to $7 million. Final disposition is unknown at this time.

Rausch, Fisch and Frost. The Supreme Court decision of Rausch, Fisch and Frost addresses the payment of the impairment rating to Permanently Totally Disabled workers. The Supreme Court, in their September 5, 2002 opinion, determined the impairment is payable upon receipt of the undisputed impairment rating and not upon retirement as was the practice. In addition, the court characterized the benefit as a permanent total benefit. Attorneys' fees were awarded pursuant to the common fund doctrine. The case was remanded to the Workers' Compensation Court for further proceedings consistent with the opinion. Briefing of issues in regards to implementation of the decision occurred with the issue of applicability to claims between 1987 and 1991 pending final resolution. The Workers' Compensation Court had ruled in favor of Montana State Fund. Implementation of the common fund was settled and approved by Judge McCarter. Implementation on the agreement is ongoing. Financial impact is immaterial in that payment of the impairment ratings is a timing issue, not additional benefits.

NOTE J - CONTINGENCIES, UNCERTAINTIES AND SUBSEQUENT EVENTS, continued

Robert Flynn v. State Compensation Insurance Fund. The Claimant, Robert Flynn, filed a petition in the Workers' Compensation Court for the State of Montana in which he alleged that the Respondent, State Compensation Insurance Fund, should pay a proportionate share of the attorney fees he incurred to recover social security disability benefits. Flynn also requested that the Court sanction the Montana State Fund for unreasonably reducing his temporary total disability benefits in an effort to recoup overpayments. The Workers' Compensation Court denied both of Flynn's claims and Flynn appealed. The Court affirmed in part and reversed in part the judgment of the Workers' Compensation Court. (1) The Court decided that pursuant to the common fund doctrine, the Montana State Fund should contribute, in proportion to the benefits it actually received, to the costs of the litigation, including reasonable attorney fees. The Workers' Compensation Court erred when it denied Flynn's request for reasonable apportionment of attorney fees. To the extent it declined to apply the common fund doctrine, the judgment of the Workers' Compensation Court was reversed by the Supreme Court. (2) The Supreme Court agreed that nothing in the record indicated that the Montana State Fund acted unreasonably in offsetting Flynn's benefits. Therefore, the Workers' Compensation Court did not err when it concluded that the Montana State Fund was entitled to reduce Flynn's disbursements to the extent that it did to recover overpaid benefits. The matter is currently on remand, and the Workers' Compensation Court ruled on August 5, 2003 on the issues of whether a common fund had been established and whether the decision should be applied retroactively. The court ruled for the claimant on both issues as follows, "Since claimant's entitlement to attorney fees is a matter of law and arose only after the decision on appeal, the post-remand request for attorney fees is timely." Also, "Whether the blanket rule of retroactivity of judicial decisions adopted by the United States Supreme Court in Harper v. Virginia Dept. of Taxation, 509 U.S. 86 (1993), or the more flexible rule from Chevron Oil C. v. Huson, 404 U.S. 97 (1971), is applied, the decision in Flynn v. State Compensation Ins. Fund, 2002 MT 279, 312 Mont. 410, 60 P.3d 397, must be applied retroactively." Settlement discussions on implementation of the common fund have been initiated. As data is not fully compiled and reviewed, no analysis of cost estimates is available at this time; however, ultimate impact is estimated at less than $1,000,000.

Schmill v. Liberty Northwest Insurance. This case, 2003 MT 80, decided April 10, 2003 by the Montana Supreme Court held as follows, "We conclude that the ODA and the WCA treat similarly situated classes of workers differently. Furthermore, apportioning Schmill's permanent impairment award for her occupational disease pursuant to § 39-72-706, MCA, of the ODA while providing full benefits for injured workers pursuant to the WCA is not rationally related to a legitimate governmental interest. Therefore, we conclude that § 39-72-706, MCA, violates the equal protection guarantee found at Article II, Section 4 of the Montana Constitution. The judgment of the Workers' Compensation Court is affirmed." Retroactive application of the decision and its status as a common fund is presently before the Workers' Compensation Court in on-going litigation. The decision of the Workers' Compensation Court will likely be appealed to the Montana Supreme Court by at least one of the parties.

Should the ultimate decision of the Montana Supreme Court be to create a common fund and apply the decision retroactively, the cost is estimated at $1.5 to $2 million dollars. Should the ultimate decision of the Montana Supreme Court be to apply the decision retroactively, the impact on the Old Fund liability for claims that occurred before July 1, 1990 is estimated at $800,000. Final disposition is unknown at this time. This was not a case against the Montana State Fund, but the holding of this decision applies to Montana State Fund. Montana State Fund's motion to intervene in the case was granted by the Workers' Compensation Court. In addition a separate case against the Montana State Fund on this same issue has been filed in the Workers' Compensation Court against Montana State Fund, Minnick.

NOTE J - CONTINGENCIES, UNCERTAINTIES AND SUBSEQUENT EVENTS, continued

Wild v. Fregein and Montana State Compensation Insurance Fund. This case, 2003 MT 115, decided April 29, 2003, primarily held that § 39-71-401(3), MCA, does not, as a matter of law, conclusively preclude any factual inquiry into whether an employer/employee relationship exists once the worker has been issued the exemption contemplated by § 39-71-401(3), MCA.", and … "that § 39-71-401(3), MCA, read in conjunction with § 39-71-120, MCA, does require the employer to make an initial good faith inquiry of the worker to determine that he or she does, in fact, meet the control and independently established business tests before the employer employs the worker as an IC and if the employer determines the worker is an IC, to thereafter treat the worker as an IC and not as an employee as Fregein treated Wild in this case." Retroactive application of the decision and its status as a common fund is presently before the Workers' Compensation Court in on-going litigation. As data on identification of potential claims is difficult to identify, no analysis of cost estimates on retroactive application of the decision is available at this time.

NOTE K - RECLASSIFICATIONS

Certain amounts in the prior year financial statements have been reclassified for comparative purposes to conform with the presentation in the current year financial statements.

NOTE L - UNASSIGNED SURPLUS - NON-ADMITTED ASSETS AND RECONCILIATION TO GAAP

	Years Ended June 30,	
	2003	2002
Balance of non-admitted assets - beginning of year	**$ 5,046,918**	$ 9,270,212
Cumulative non-admitted DAC	**878,106**	-
Subtotal	**5,925,024**	9,270,212
Increase (decrease) in non-admitted assets:		
Change in premiums receivable	**769,828**	(565,160)
Change in short-term notes and loans receivable	**(24,458)**	71,011
Change in bond downgrades	**360,145**	(904,256)
Change in net tangible assets	**(40,060)**	(15,645)
Change in intangible assets	**(987,467)**	(2,917,876)
Increase in other assets	**78,814**	108,632
Net increase (decrease) in non-admitted assets	**156,802**	(4,223,294)
Balance of non-admitted assets - end of year	**$ 6,081,826**	$ 5,046,918

The following schedule reconciles Statutory Surplus calculated in accordance with NAIC SAP to Net Assets as determined by generally accepted (governmental) accounting principles at June 30:

	2003	2002
Statutory Surplus (NAIC SAP)	**$ 121,599,417**	$ 158,498,995
Add:		
Non-admitted assets as shown above	**6,081,826**	5,046,918
Change in investment value of bonds to fair market value	**35,546,942**	16,651,580
Less the portion of the change in investment value recognized for GAAP	**(720,462)**	-
The change in net income between NAIC SAP and GAAP for:		
Deferred acquisition costs	**596,232**	517,790
Reversal of small adjustment and other	**(10,140)**	-
Net assets (GAAP)	**$ 163,093,815**	$ 180,715,283

NOTE M - SUPPLEMENTAL INVESTMENT RISK INFORMATION

MSF's largest ten exposures to a single issuer/borrower/investment, listed by investment category (excluding U.S. government-related securities) are:

June 30, 2003	Amount	% of Total Admitted Assets
Industrial & Misc. Other Multi-Class Comm. Mrtg./Asset-Backed Securities	$ 14,697,335	2.513%
Industrial & Misc. Other Multi-Class Comm. Mrtg./Asset-Backed Securities	9,959,721	1.703%
Industrial & Misc. U.S. Unaffiliated Issuer Obligations	8,152,315	1.394%
Public Utilities	5,996,554	1.025%
Industrial & Misc. U.S. Unaffiliated Issuer Obligations	5,344,042	0.914%
Industrial & Misc. U.S. Unaffiliated Issuer Obligations	5,244,872	0.897%
Industrial & Misc. U.S. Unaffiliated Issuer Obligations	5,181,005	0.886%
Industrial & Misc. U.S. Unaffiliated Issuer Obligations	5,168,927	0.884%
Industrial & Misc. U.S. Unaffiliated Issuer Obligations	5,036,880	0.861%
Industrial & Misc. U.S. Unaffiliated Issuer Obligations	5,031,611	0.860%

June 30, 2002	Amount	% of Total Admitted Assets
Common Stock	$ 64,180,639	11.163%
Industrial & Misc. U.S. Unaffiliated Issuer Oblig.	13,636,000	2.372%
Industrial & Misc. Multi-class Mrtg./Asset Back Oblig.	10,000,927	1.740%
Industrial & Misc. U.S. Unaffiliated Issuer Oblig.	9,955,251	1.732%
Industrial & Misc. U.S. Unaffiliated Issuer Oblig.	8,521,561	1.482%
Industrial & Misc. U.S. Unaffiliated Issuer Oblig.	6,724,316	1.170%
Industrial & Misc. U.S. Unaffiliated Issuer Oblig.	5,993,807	1.043%
Industrial & Misc. U.S. Unaffiliated Issuer Oblig.	5,258,940	0.915%
Public Utilities Unaffiliated Issuer Oblig.	5,050,557	0.878%
Industrial & Misc. U.S. Unaffiliated Issuer Oblig.	5,027,192	0.874%

The amounts and percentages of MSF's total admitted assets held in bonds by NAIC rating are:

June 30, 2003	Amount	% of Total Admitted Assets
NAIC-1	$ 348,516,479	59.592%
NAIC-2	80,969,218	13.845%
NAIC-3	7,332,601	1.254%
Total Bonds	436,818,298	74.691%

June 30, 2002	Amount	% of Total Admitted Assets
NAIC-1	$ 305,010,454	53.052%
NAIC-2	97,088,339	16.887%
NAIC-3	12,833,525	2.232%
NAIC-6	390,000	0.068%
Total Bonds	415,322,318	72.239%

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INDEPENDENT AUDITORS' REPORT

To the Board of Directors
Montana State Fund
Helena, Montana

We have audited the accompanying statutory statements of admitted assets, liabilities and surplus of Montana State Fund (New Fund), a component unit of the State of Montana, at June 30, 2003 and 2002, and the related statutory statements of revenue and expenses, changes in surplus and cash flows for the years then ended. These financial statements are the responsibility of the company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform our audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As described more fully in Note A, to the financial statements, the Company prepared these financial statements in conformity with accounting practices prescribed or permitted by the Insurance Department of Montana, which practices differ from accounting principles generally accepted in the United States of America. The effects on the financial statements of the variances between statutory accounting practices and accounting principles generally accepted in the United States of America are described in Note L.

In our opinion, the financial statements referred to in the first paragraph present fairly, in all material respects, the admitted assets, liabilities, and surplus (statutory basis) of Montana State Fund for the years ended June 30, 2003 and 2002, and results of its operations, changes in surplus and cash flows (statutory basis) for the years ended June 30, 2003 and 2002 on the basis of accounting described in Note A.

However, because the company prepares its financial statements on a statutory basis of accounting, as discussed in the preceding paragraph, it is our opinion, that the financial statements referred to above do not present fairly, in conformity with accounting principles generally accepted in the United States of America, the financial position of Montana State Fund for the years ended June 30, 2003 and 2002 or the results of its revenue and expenses, changes in surplus and cash flows for the years then ended.

Galusha, Higgins & Galusha, PC

GALUSHA, HIGGINS AND GALUSHA, PC
Certified Public Accountants and Advisors

Helena, Montana
January 16, 2004

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Tillinghast - Towers Perrin

December 19, 2003

To The Board of Directors of the Montana State Fund:

Tillinghast – Towers Perrin was engaged by the Montana State Fund (MSF) to estimate the unpaid loss and loss adjustment expenses as of June 30, 2003, for MSF's workers' compensation exposures. Our examination included the performance of independent projections of MSF's loss and loss expense liabilities and such other tests and procedures as we considered necessary in the circumstances. We relied on MSF personnel as to the completeness and accuracy of the data.

Our estimated loss and loss adjustment expense liability as of June 30, 2003, is $406.7 million, undiscounted, and net of reinsurance recoverables. MSF has recorded a provision of $413.4 million on its June 30, 2003 balance sheet for unpaid loss and loss adjustment expense.

In our opinion, the amounts recorded in the balance sheet as reserves for estimated loss and loss adjustment expense liabilities: (1) Are consistent with amounts calculated in accordance with commonly accepted actuarial methods and are fairly stated on an ultimate undiscounted basis in accordance with sound actuarial principles; (2) Are consistent with amounts based upon actuarial assumptions which are reasonable given the coverages provided; and (3) Make good and sufficient provision in the aggregate for all unpaid loss and loss adjustment expense obligations.

The Policyholders' Surplus of MSF as of June 30, 2003, is $121.6 million, using statutory accounting principles. Current year premium revenue was $117.8 million. We note that the Policyholders' Surplus level of MSF is consistent with traditional industry standards. We believe that it is prudent for MSF to set a long-term goal of maintaining appropriate surplus based on industry standards.

VARIABILITY

Loss and loss adjustment expense reserve estimates are subject to considerable uncertainty due to the fact that the ultimate liability for claims is subject to the outcome of events yet to occur. In evaluating whether the reserves make a reasonable provision for unpaid losses and loss expenses, it is necessary to project future loss and loss adjustment expense payments. Actual future losses and loss adjustment expenses will not develop exactly as projected and may, in fact, vary significantly from the projections.

Robert F. Conger
Fellow, Casualty Actuarial Society
Member, American Academy of Actuaries

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